the cash and the value of the buildings contributed to it.

In Section 30.718-1 of Treasury Regulations 109 (Appendix, *infra*, p. 17), it is provided that for the purpose of determining equity invested capital, the amount of any property paid in is the unadjusted basis to the taxpayer for determining loss upon a sale or exchange under the law applicable to the taxable year for which the invested capital is being computed. This regulation conforms to the intent of the statute which provides, for example, in Section 718(a)(2) of the Code that "Such property [property paid in] shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange."

Since, as we have seen under point 1 above, the petitioner may not include in its basis for depreciation, which is the same as for gain or loss, an investment in property which it has not made, it similarly is precluded by the regulations and by the statute from including in equity invested capital an investment in property which it has not made. This is also the conclusion in *McKay Products Corp.* v. *Commissioner*, *supra*, 9 T. C. at p. 1096. See also *Liberty Mirror Works* v. *Commissioner*, 3 T. C. 1018.

This conclusion is further fortified by the legislative history of the excess profits tax provisions here in question which, we submit, makes it clear that only capital *risked* by a corporation is includi-

ble in its equity invested capital under Section 718(a)(1) and (2), as a basis for determining its normal earnings not subject to the excess profits tax. See the Report of the Subcommittee of the Committee on Ways and Means made August 8, 1940, on the proposed excess profits tax and special amortization, 76th Congress, 3d Sess., p. 3.

In cases involving the invested capital provisions of Section 207 of the Revenue Act of 1917, c. 63, 40 Stat. 300, it was also held that invested capital was confined to money or money's worth actually paid out in acquiring an interest in a business with a view to obtaining income or profits from the conduct of the business, and therefore, the cost of property donated to a corporation by nonstockholders could not become a part of invested capital. *Frank Holton & Co.* v. *Commissioner*, 10 B. T. A., 1317; *A. C. F. Gasoline Co.* v. *Commissioner*, 6 B. T. A. 1337. And in *LaBelle Iron Works* v. *United States*, 256 U. S. 377, 387-388, this Court pointed out that the dominant purpose of Congress was to place the peculiar burden of the tax under the earlier law upon the income of trades and businesses exceeding that which was deemed a normal reasonable return upon the capital *actually embarked* by the corporation in the business. The experience under the 1917 and 1918 laws was undoubtedly used by Congress as a guide in framing the 1940 excess profits tax law. See *Commissioner* v. *South Texas Co.*, 333 U. S. 496, 501.

3. The petitioner's alternative and inconsistent contention (Pet. 16-19) that, in any event, the buildings transferred to it and payments made to it are includible in equity invested capital under Section 718(a)(4) of the Code (Appendix, *infra*, p. 17) as "accumulated earnings and profits" was also correctly rejected below.

The petitioner does not contend that upon the receipt of such buildings and payments it realized taxable income which was recognized for tax purposes, nor did it in fact report such receipts as taxable income, presumably in reliance upon *Edwards v. Cuba Railroad*, 268 U. S. 628.

We contend that to recognize the values here in question as affecting earnings and profits would no more harmonize with the taxless character of the transaction than would the realized but unrecognized gains in *Commissioner v. Wheeler*, 324 U. S. 542, or the unrecognized gains on installment sales in *Commissioner v. South Texas Co.*, 333 U. S. 496. As held by this Court in the *Wheeler* case, the policy of the revenue laws requires the use of the same basis in determining gains and losses which are to be brought into "earnings and profits" as that used in determining the gains and losses which are to be brought into the income account for the corporation's income tax. Here, as we have seen under point 1 above, the basis for determining gain or loss and for depreciation on the investments in the buildings which the petitioner has not made,

is zero, and hence that is the basis for determining the amounts which may be included in "earnings and profits". Only at the time and to the extent that the petitioner realizes income from these investments which is recognized for income tax purposes may the "earnings and profits" account be increased. *Commissioner* v. *South Texas Co.*, *supra*. The court below properly applied these principles to the present case.

CONCLUSION

The decision below correctly applies principles which have been announced by this Court. There is no conflict among the circuits. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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DECEMBER, 1949.

APPENDIX

STATUTE AND REGULATIONS INVOLVED IN THE EQUITY INVESTED CAPITAL ISSUE

Internal Revenue Code:

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—* * *

* * * * *

(8) *Property Acquired by Issuance of Stock or as Paid-In Surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities); or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * *

(26 U. S. C. 1946 ed., Sec. 113.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203(a)(3) and section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b). *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be con-

sidered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

* * * * *

(l) [As added by Sec. 501 (a), Second Revenue Act of 1940, c. 757, 54 Stat. 974] *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (a), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. * * *

* * * * *

(26 U. S. C., 1946 ed., Sec. 115.)

SEC. 718 [As added by Sec. 201. Second Revenue Act of 1940, *supra*]. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money Paid In.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) *Property Paid In.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal

to its basis (unadjusted) for determining loss upon sale or exchange.

* * * * *

(4) *Earnings and Profits at Beginning of Year.*—The accumulated earnings and profits as of the beginning of such taxable year;

* * * * *

(26 U. S. C. 1946 ed., Sec. 718.)

Treasury Regulations 109, promulgated under the Internal Revenue Code:

SEC. 30.718-1. *Determination of daily equity invested capital—Money and property paid in.*—The equity invested capital for any day is determined as of the beginning of such day. The basis or starting point is found in the amount of money and property previously paid in for stock, or as paid-in surplus, or as a contribution to capital. For the purpose of determining equity invested capital, the amount of any property paid in is the unadjusted basis to the taxpayer for determining loss upon a sale or exchange under the law applicable to the taxable year for which the invested capital is being computed. * * *

* * * * *

If the property was acquired after December 31, 1920, by a corporation from a shareholder as paid-in surplus or from any person as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor if the transfer had not been made. * * *

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.113(a)(8)-1. *Property Acquired by a Corporation After December 31, 1920.*—The acquisition of property by a corporation after December 31, 1917, by the issuance of its stock or securities may not fall within the provisions of section 113(a) (7), because of the fact that the property was not acquired in connection with a reorganization. If, however, the acquisition of such property occurred after December 31, 1920, and falls within the provisions of section 113(a) (8), the limitations therein imposed upon the basis of such property are applicable.

In respect of property acquired by a corporation after December 31, 1920, from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property in the hands of the corporation is the basis which the property would have had in the hands of the transferor if the transfer had not been made. In the case of property acquired by a corporation after December 31, 1920, as a gift, the basis thereof shall be determined under section 113(a) (2).

Section 19.113(a)(8)-1 of Treasury Regulations 103 is substantially the same as the above-quoted Section 29.113(a)(8)-1 of Treasury Regulations 111.

Treasury Regulations 112, promulgated under the Internal Revenue Code:

SEC. 35.718-1. *Determination of Daily Equity Invested Capital—Money and Property Paid In.*—

* * *

If the property was acquired after December 31, 1920, by a corporation from a shareholder as paid-in surplus or from any person as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor if the transfer had not been made. (See section 113(a) (8).)- If so acquired prior to January 1, 1921, the basis is the fair market value of the property at the time it was paid in. Where the basis is the transferor's basis, those adjustments shall be made to such basis with respect to the period before the property was paid in as are proper under section 115(l) for determining earnings and profits. Thus, if A paid into a corporation in 1930 as paid-in surplus certain improved real estate purchased by him in 1920 for $20,000, with respect to which depreciation was allowed for the period held by him in amounts aggregating $6,000 (the full amount allowable), A's basis of $20,000 shall be reduced by $6,000 for the purpose of computing the invested capital of the corporation.

STATUTE INVOLVED IN THE DEPRECIATION ISSUE

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(l) [As amended by Sec. 121(*c*), Revenue Act of 1942, c. 619, 56 Stat. 798] *Depreciation.*—A reasonable allowance for the exhaustion, wear and

tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business

* * *

* * * * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * * *

(26 U. S. C. 1946 ed., Sec. 23.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property;

* * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

* * * * * *

(26 U. S. C. 1946 ed., Sec. 113.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113(b)

for the purpose of determining the gain upon the sale or other disposition of such property.

* * * * *

(26 U. S. C. 1946 ed., Sec. 114.)

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